

# Chapter 2

## Taxation of Financial Arrangements

### Aligning accounting and taxation treatment of transactions

2.1 The bill aims to minimise the extent to which taxation rules distort decisions, and to lower compliance costs.<sup>1</sup> One way in which compliance costs would be reduced is by aligning the treatment of transactions for tax purposes with that in accounting standards. Accordingly, the bill reflects the adoption in Australia of International Financial Reporting Standards in 2005.

2.2 However, the bill does not completely align the calculation of profit for taxation purposes with that for accounting purposes, which might be argued to be the most efficient and simple approach. As Treasury put it:

...tax and accounting do have different purposes, and there are lots of reasons why the tax in the TOFA bill does not follow the accounting in all the cases.<sup>2</sup>

2.3 In general the bill aims to treat all gains and losses on financial arrangements as revenue rather than capital items. This implies that gains will be assessable income and losses will generally be deductible.<sup>3</sup> It aims to align the tax treatment of derivatives with underlying assets, so that a hedge which is effective in pre-tax terms is also effective in post-tax terms.<sup>4</sup>

2.4 However, the bill only *allows* the use of 'fair value'<sup>5</sup> accounting. It does not *require* it, on the grounds that it 'could result in taxpayers being required to pay tax on large, unsystematic, unrealised gains which do not eventuate, potentially causing cash flow difficulties' and 'excessive volatility' in required tax payments.<sup>6</sup>

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1 *EM*, p. 7.

2 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

3 Losses are deductible 'to the extent that they are made in gaining or producing assessable income or are necessarily made in carrying on a business for the purpose of gaining or producing assessable income, unless otherwise specified', *EM*, p. 118. This is consistent with the 'nexus provision' of section 8-1 of the *Income Tax Assessment Act 1997*.

4 *EM*, p. 467.

5 The 'fair value' is defined in Australian Accounting Standard AASB 139 as 'the amount for which an asset could be exchanged or a liability settled, between knowledgeable willing parties in arm's length transactions'; *EM*, p. 226.

6 *EM*, pp 12 and 227.

## Provisions of the bill

2.5 In simple terms, 'financial arrangements' include loans, bonds, equities (shares) and derivatives (forwards, options and swaps). Where payment for a purchase of goods occurs more than a year after their delivery, this is also covered. Provisions in the bill mean that foreign currency and commodities held by traders are also covered.<sup>7</sup> Insurance policies and retirement village contracts are not included.<sup>8</sup>

2.6 However, there are limits on the deductibility of interest on some 'debt-equity hybrids', in order to prevent companies disguising dividends as tax-deductible interest payments.<sup>9</sup>

2.7 The bill provides a range of elective methods for determining gains and losses from financial arrangements:

- fair value method, where the taxpayer prepares their books using relevant accounting standards;
- retranslation method, applying 'fair value' to gains and losses attributable to movements in foreign currency exchange rates;
- elective hedging method, more closely aligning the tax treatment of the 'hedging financial arrangement' (i.e. a derivative or a forex hedge) with that of the item it hedges (and therefore allowing the deferral of tax on gains from a string of rolling hedges until the underlying event occurs);
- financial reports method, only available to taxpayers with unqualified financial reports and robust accounting systems;
- compounding accruals method (the default option where there is a *sufficiently certain* gain or loss that can be calculated *with reasonable accuracy*), involving amortising using an 'effective interest rate' (the same thing as the internal rate of return) which smoothes gains or losses in comparison to the 'fair value' approach; or
- realisation method (the default option when there is not a sufficiently certain gain or loss).

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7 The Government recently announced that they intend for derivatives based on carbon permits to be treated as financial arrangements; *White Paper on the Carbon Pollution Reduction Scheme*, pp 14-21.

8 This is a simplification of what is in the bill: the definition of 'financial arrangements' in the *EM* takes 67 pages!

9 There is a cap set on the interest rate on hybrids of 150 basis points above that prevailing on otherwise comparable debt instruments. The cap can be varied by regulation; *EM*, pp 119-20.

2.8 However, there are safeguards to avoid taxpayers using different methods for different assets or in different years just to allow them to pay the least tax.

2.9 The legislation generally does not apply to the following (although there are exceptions):

- individuals;
- superannuation funds with assets under \$100 million;
- authorised deposit-taking institutions with annual turnover under \$20 million; and
- other entities with annual turnover under \$100 million, financial assets under \$100 million and total assets under \$300 million.

2.10 CPA Australia suggests that the latter turnover test be raised from \$100 million to \$250 million, pointing out that \$250 million is the Tax Office's large business benchmark.<sup>10</sup> The Government rejected this view 'because of the potential for increased tax arbitrage'.<sup>11</sup>

2.11 The Institute of Chartered Accountants do not object to the \$100 million threshold, but think it should be the sole threshold, not combined with thresholds related to assets.<sup>12</sup>

## Costs

2.12 The ATO estimates there are around 1,800 businesses with turnover exceeding \$100 million. While they may incur some initial costs in changing software and paying advisers, they should reap gains from aligning tax and accounting reporting and from hedging arrangements being less subject to disruption from tax effects. The Taxation Institute believes that 'there should be massive compliance cost savings'.<sup>13</sup>

2.13 The Government has not commented on revenue implications but the Taxation Institute believe it would bring forward some tax receipts.<sup>14</sup> The Treasury submission gives an example of how the current treatment of interest rate swaps gives rise to a 'potential tax mischief', an anomaly which the bill would resolve.<sup>15</sup>

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10 Cited in *Australian Financial Review*, 5 December 2008.

11 *EM*, p. 482.

12 Institute of Chartered Accountants, *Submission 5a*.

13 Cited in *Australian Financial Review*, 5 December 2008.

14 Cited in *Australian Financial Review*, 5 December 2008.

15 Treasury, *Submission 1*, p. 2.

## **Education arrangements**

2.14 The bill is complex. However, it only affects large taxpayers and there has been a long consultation process during which these taxpayers will have gained some familiarity with it. Furthermore, the Australian Tax Office is putting in place procedures to advise and assist taxpayers on complying with the new requirements.<sup>16</sup>

## **Timing of implementation**

2.15 The new provisions will apply to all financial arrangements started from July 2010. Taxpayers may also choose for it to apply to arrangements in place at July 2009.<sup>17</sup> Where this gives rise to a transitional balancing adjustment, this can be spread over four years.

2.16 The current period is one of unusually large falls in asset values. Treasury did not regard this as a reason to defer introducing the bill:

I am not sure whether it will facilitate it or make it more difficult for them to come in.<sup>18</sup>

## **Technical comments on the bill**

2.17 Deloitte suggested two technical amendments to the bill. One would 'make it clear that an accrued gain or loss should only be brought to account in the year in which the election or withdrawal of the election has effect'. Treasury believe this will be addressed in other legislation.<sup>19</sup> The other proposal by Deloitte would amend a transitional arrangement, to address a concern that 'the term "have", as used in Item 104 of the transitional provisions is not a defined term'.<sup>20</sup> Treasury regard this as something to be monitored once the bill is passed.<sup>21</sup>

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16 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 2.

17 *EM*, p. 409.

18 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

19 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, pp 3-4.

20 Deloitte, *Submission 9*, pp 2-5.

21 Mr Roger Paul, Treasury, *Proof Committee Hansard*, 16 February 2008, p. 4.

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## General attitude towards the bill

2.18 PriceWaterhouseCoopers 'supports the immediate passage of the ToFA bill in its current form through parliament'<sup>22</sup>, as does the Taxation Institute of Australia; the Investment and Financial Services Association; the Institute of Chartered Accountants; the Australian Bankers' Association; the Australian Financial Markets Association; the Property Council of Australia and Deloitte.<sup>23</sup>

2.19 Many submitters commented that after the legislation is implemented, there may be a need for some 'fine-tuning' of some aspects.<sup>24</sup> But it is impossible to predict these beforehand, and the submitters argue this is no reason to delay passing the bill. Instead there should be some post-implementation review process. The possible need for later technical amendments is acknowledged by both the Government and Opposition:

There will be reason to monitor its implementation and to make minor amendments as we go...there are likely to be finetuning issues that arise, and we stand ready to implement those on a case-by-case basis...<sup>25</sup>

...it is also recognised that there will be future amendments, once this bill is passed, dealing with technical issues.<sup>26</sup>

## Recommendation

2.20 **The committee recommends that the Senate pass the bill.**

## Senator Annette Hurley

### Chair

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22 PriceWaterhouseCoopers, *Submission 2*, p. 1.

23 Taxation Institute, *Submission 3*, p. 1; IFSA, *Submission 4*, p. 1; ICA, *Submission 5*, p. 1; ABA, *Submission 6*, p. 1; AFMA, *Submission 7*, p. 2; Property Council of Australia, *Submission 8*, p. 1; Deloitte, *Submission 9*, p. 1.

24 Treasury, *Submission 1*, p. 2; PriceWaterhouseCoopers, *Submission 2*, pp 1-3; IFSA, *Submission 4*, p. 2; ICA, *Submission 5*, p. 1; ABA, *Submission 6*, p. 1; AFMA, *Submission 7*, p. 2; Deloitte, *Submission 9*, p. 1.

25 The Hon Chris Bowen MP, *House of Representatives Hansard*, 11 February 2009, p. 70.

26 Mr Anthony Smith MP, *House of Representatives Hansard*, 11 February 2009, p. 69.

